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SUBJECT: AUSTRIA'S 2006/2007 OUTLOOK - HIGHER GROWTH

REFS: 05 VIENNA 3495

Summary

1. Austria's two leading economic institutes have revised 2006 growth projections upward to 2.3-2.4%, based on stronger demand in export markets and a modest recovery of business investment. However, the 2007 growth rate should slow to 2.0-2.2%, as German demand dampens after implementation of a higher VAT. Exports remain the driving force behind GDP growth, as comparatively low unit wage costs and strong productivity growth will enable exporters to benefit from increased demand in traditional markets. The unemployment rate should remain at 5.2% in 2006, but rise to 5.3% in 2007, as projected economic growth will be insufficient to effect an increase in labor demand. Inflation should ease from 2.3% in 2005 to below 2.0% in 2006/07, assuming more stable energy prices. End Summary.

Growth in 2006/07 - Light at the End of the Tunnel?

2. The Austrian Institute for Economic Research (WIFO) and the Institute for Advanced Studies (IHS) recently presented revised projections for 2006 and an initial forecast for 2007. Both institutes upgraded growth expectations from previous prognoses (reftel), based on stronger export demand and a projected, modest recovery of investments and private consumption. WIFO raised its 2006 growth forecast from 1.8% to 2.4% and IHS its estimate from 2.1% to 2.3%. Projections for 2007 are for slightly lower growth of 2.0-2.2%. Austrian exports will continue to propel economic growth in 2006, benefiting from a generally favorable global environment and increased demand in Germany prior to the 2007 VAT increase.

3. For 2007, the institutes predict slightly lower economic growth, as the full effect of higher VAT in Germany dampens export growth in Austria. Consolidating modest growth rates in 2006-2007 will require that export growth encourages stronger business investment, which has been very weak in 2004-2005. WIFO Director Karl Aiginger cautioned that private consumption remains hampered by moderate income growth and a high savings rate. Since 2000, private consumption has grown only 1% in real terms and should only grow around 2% in 2006-2007. The savings rate should decrease only slightly to 9.0-9.5% in 2006-2007.

4. Exports remain key for Austria's economic growth. In 2005, Austrian exporters lost market shares in Central and Eastern Europe, as well as in Western Europe. Economists interpreted this as a correction of the very large market shares obtained in 2004. With declining unit wage costs (25% below 1995 levels), resulting from moderate wage increases and strong productivity growth, Austrian exporters are well positioned to benefit from anticipated economic upswings in important markets, such as Germany, Southeastern Europe, and oil-exporting countries.

Risks for the Forecasts - Oil Prices and Exchange Rates

5. Main short-term risks for the forecasts are volatile energy prices and an uncertain Euro/dollar exchange rate. Moreover, in 2007, German demand will most likely diminish, as the VAT increase takes effect. WIFO and IHS cautioned that a moderate weakening of U.S. economic growth also represents a downside risk. However, there is also an upward risk, should business investment improve significantly and private consumption overcome its five-year weakness.

Assumptions for Growth Forecasts

6. The institutes based their 2006/2007 forecasts on the

following assumptions:

-- U.S. economic growth of 3.0-3.3% in 2006 and 3.0 in 2007;
 -- Euro area growth of 2.0-2.1 in 2006 and 1.8-1.9% in 2007;
 -- EU-25 growth of 2.2-2.3% in 2006 and 2.0% in 2007;
 -- German growth of 1.8-1.9% in 2006 and 1.2-1.5% in 2007;
 -- oil prices of \$53-57 per barrel in 2006 and \$50-62 in 2007; and
 -- dollar/Euro exchange rates of 0.81-0.86 in 2006 and 0.81-0.89 in 2007.

Other Forecasts

17. The results of the WIFO and IHS forecasts track with those of other institutions. The IMF's September 2005 World Economic Outlook projects economic growth of 2.2% in 2006 for Austria, while the European Commission's fall 2005 Economic Forecast predicts growth rates of 1.9% in 2006 and 2.2% in 2007. The Austrian National Bank's December 2005 forecast is for 2.3% growth in 2006 and 2007. Bank Austria Creditanstalt, Austria's largest commercial bank, is more pessimistic, projecting growth of 2.0% in 2006, but only 1.7% in 2007, based on a weakening global economy, the VAT increase in Germany, and restrictive budgetary policies in the Euro area.

Inflation Easing, Unemployment A Persistent Problem

18. Assuming more stable external factors, particularly more stable oil prices, inflation should ease from 2.3% in 2005 to 1.8-1.9% in 2006 and 1.6-1.9% in 2007.

19. Per capita gross wages will increase 2.8-2.9% in 2006 and 2.5-2.7% in 2007. Due to continued strong hourly productivity growth of 4-5% in industry, unit labor costs in industry will drop about 1.7% both years, helping to improve Austria's international competitiveness.

10. Despite higher economic growth in 2006/07 and employment growth of close to 1.0% in both years, Austria's unemployment rate will not decline from its current level of 5.2%. The projected economic growth will be insufficient to create substantial additional labor demand, offsetting the expansion of labor supply. Only an increase in the number of those in training programs, and therefore not statistically unemployed, will prevent a further rise in the unemployment rate.

Public Finance

11. The GoA's corporate/income tax cut will push the 2005 total public sector deficit to 1.7% of GDP. In 2006, cost-savings from administrative reform will not offset the continued impact of the tax cut, a civil service wage increase and higher expenses for labor market and R&D programs. Therefore, the institutes again expect a deficit of close to 2.0% of GDP. Assuming the GoA undertakes measures to cut the deficit, the institutes project the total public sector deficit to come down to 1.5% in 2007. The GoA's 2005-2008 Stability Program, published in November 2005, foresees a deficit of 0.8% of GDP in 2007 and a balanced total public sector budget in 2008.

12. Statistical Annex

Austrian Economic Indicators (percent change from previous year, unless otherwise stated)

	WIFO project. 2006	IHS project. 2006	WIFO project. 2007	IHS project. 2007
Real terms:				
GDP	2.4	2.3	2.0	2.2
Manufacturing	4.3	n/a	3.7	n/a
Private consumption	1.8	1.9	2.0	1.8
Public consumption	1.0	1.0	0.5	0.5
Investment	2.7	3.1	2.4	3.0
Exports of goods	6.5	5.7	5.7	5.5
Imports of goods	5.3	5.0	5.2	4.8

Nominal Euro billion equivalents:

GDP	256.2	256.2	266.3	265.7
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Other indices:

GDP deflator	1.9	1.8	1.9	1.5
Consumer prices	1.9	1.8	1.9	1.6
Unemployment rate	5.2	5.3	5.2	5.3

Current account (in percent of GDP)	0.3	0.5	0.3	0.6
Exchange rate for US\$ 1.00 in Euro	0.86	0.81	0.89	0.81

McCaw